

Full Council

13 December 2016



Report of: Service Director - Finance

Title: Treasury Management Mid-Year Report 2016/17

Ward: Citywide

Member Presenting Report: Cllr Craig Cheney, Cabinet member for Finance, Governance and Performance

Recommendation

That the Mid-Year Treasury Management report for 2016/17 is noted.

Summary

This report meets the treasury management regulatory requirement that the Council receive a mid-year treasury review report. It also incorporates the needs of the Prudential Code to ensure adequate monitoring of the capital expenditure plans.

The significant issues in the report are:

There are no policy changes to the TMSS; the details in this report update the position in the light of the updated economic position and budgetary changes. The authority has identified a medium term borrowing requirement of £150m and is planning on borrowing £20m at a preferential rate from the PWLB that expires on the 31st March.



Policy

1. Not applicable

Consultation

2. **Internal**
Audit Committee
3. **External**
The Council's Treasury Management advisers

Purpose of the report:

4. This report meets the treasury management regulatory requirement that the Council receive a mid-year treasury review report. It also incorporates the needs of the Prudential Code to ensure adequate monitoring of the capital expenditure plans and the Council's prudential indicators (PIs).
5. That the mid-year report is structured to highlight:
 - The economic outlook;
 - The actual and proposed treasury management activity (borrowing and investment);
 - The key changes to the Council's capital activity (the prudential indicators {PIs}).

Background

6. Treasury management is defined as:

"The management of the local authority's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."

7. The Council operates a balanced budget, which broadly means cash raised during the year will meet its cash expenditure. Treasury management operations aim to ensure that cash flow is adequately planned, with surplus monies being invested in low risk counterparties, providing adequate liquidity initially before considering optimising investment return.
8. The second main function of the treasury management service is the funding of the Council's capital plans. These capital plans provide a guide to the borrowing need of the Council, essentially the longer term cash flow planning to ensure the Council can meet its capital spending operations. The management of longer term cash may involve arranging long or short term loans, or using longer term cash flow surpluses, and on occasion any debt previously drawn may be restructured to meet Council risk or cost objectives.

Introduction

9. The Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised in 2011) has been adopted by this Council. The primary requirements of the Code are:
 - Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities;

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- Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives;
 - Receipt by the full council of an annual Treasury Management Strategy Statement - including the Annual Investment Strategy and Minimum Revenue Provision Policy - for the year ahead, a **Mid-year Review Report** and an Annual Report (stewardship report) covering activities during the previous year;
 - Delegation by the Council of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions;
 - Delegation by the Council of the role of scrutiny of treasury management strategy and policies to a specific named body. For this Council the delegated body is Audit Committee.
10. This mid-year report has been prepared in compliance with CIPFA's Code of Practice on Treasury Management, and covers the following:
- An economic update for the 2016/17 financial year to 30 September 2016;
 - A review of the Treasury Management Strategy Statement and Annual Investment Strategy;
 - A review of the Council's investment portfolio for 2016/17;
 - A review of the Council's borrowing strategy for 2016/17;
 - A review of any debt rescheduling undertaken or planned during 2016/17;
 - The Council's capital expenditure and (prudential indicators);
 - A review of compliance with Treasury and Prudential Limits for 2016/17.

Key Changes to the Treasury and Capital Strategies

11. There are no policy changes to the TMSS; the details in this report update the position in the light of the updated economic position and budgetary changes.
12. The 2016–2019 Treasury Strategy (approved 16th February 2016) identified a medium term borrowing requirement of £150m to support the existing and future Capital Programme with the debt servicing costs met from revenue savings from capital investment and the economic development fund. The Council's agreed policy is to defer borrowing while it has significant levels of cash balances (£135m at September 2016, £70m estimated for March 2017). The authority is planning on borrowing £20m at a preferential rate from the PWLB that expires on the 31st March for the Bristol Temple Meads East Regeneration (Arena) scheme with the net financing costs contained within the existing capital financing budget. No further borrowing is anticipated in the current financial year, unless:
- short term investments fall at a higher pace than expected increasing the liquidity risk of the authority and or;
 - there is a significant change in markets (debt financing costs continue to be at historic low levels) and long term borrowing is deemed advantageous the authority will borrow over periods determined as the most appropriate to reduce the authorities exposure to interest rate risk.

Analysis of Debt and Investments

13. A summary of the of the Council's debt and Investment position as at 30th September 2016 (including forecast at 31st March 2017) compared with 31st March 2016 is shown in the table below:

Debt & Investments	31 st March 2016		31 st September 2016		31 st March 2017	
	£m	Rate%	£m	Rate%	£m	Rate%
Long Term Debt – PWLB	292	5.09	292	5.09	312	5.05
Long Term Debt – Market – LOBO*	100	4.11	100	4.11	100	4.11
Long Term Debt – Market - Fixed	23	4.24	23	4.24	23	4.24
Short Term Borrowing	2	0.55	-	-	-	-
Total Debt	417	4.81	415	4.81	435	4.77
Investment	146	0.63	135	0.60	70	0.50
Net Borrowing Position	271		280		365	

*Lender option Borrower option

14. We are currently achieving a return of 0.60% on our investments for the period to 30th September 2016. The return for the year is anticipated to fall following the recent change in base rate to 0.25% on the 4th of August with investment rates falling in line with this change. Economists are also forecasting a further cut in base rate to 0.1% around the turn of the calendar year. Long term interest rates are expected to remain at or around 2.30% (for 25 year term).

Economic Update to review

15. **UK** - UK GDP growth rates in 2013 of 2.2% and 2.9% in 2014 were strong but 2015 was disappointing at 1.8%, though it still remained one of the leading rates among the G7 countries. Growth improved in quarter 4 of 2015 from +0.4% to 0.7% but fell back to +0.4% (2.0% y/y) in quarter 1 of 2016 before bouncing back again to +0.7% (2.1% y/y) in quarter 2. During most of 2015, the economy had faced headwinds for exporters from the appreciation during the year of sterling against the Euro, and weak growth in the EU, China and emerging markets, plus the dampening effect of the Government's continuing austerity programme. The referendum vote for Brexit in June this year delivered an immediate shock fall in confidence indicators and business surveys, pointing to an impending sharp slowdown in the economy. However, subsequent surveys have shown a sharp recovery in confidence and business surveys, though it is generally expected that although the economy will now avoid flat lining, growth will be weak through the second half of 2016 and in 2017.
16. The Bank of England meeting on August 4th addressed this expected slowdown in growth by a package of measures including a cut in Bank Rate from 0.50% to 0.25%. The Inflation Report included an unchanged forecast for growth for 2016 of 2.0% but cut the forecast for 2017 from 2.3% to just 0.8%. The Governor of the Bank of England, had warned that a vote for Brexit would likely cause a slowing in growth, particularly from a reduction in business investment, due to the uncertainty of whether the UK would have continuing full access, (i.e. without tariffs), to the EU single market. The governor also warned that the Bank will need the Government to support growth by increasing investment expenditure and possibly by using fiscal policy tools (taxation).

The new Chancellor Phillip Hammond announced after the referendum result, that the target of achieving a budget surplus in 2020 will be eased in the Autumn Statement on November 23.

17. The Inflation Report included a sharp rise in the forecast for inflation to around 2.4% in 2018 and 2019. CPI has started rising during 2016 as the falls in the price of oil and food twelve months ago fall out of the calculation during the year and, in addition, the post referendum 10% fall in the value of sterling on a trade weighted basis is likely to result in a 3% increase in CPI over a time period of 3-4 years. However, the MPC is expected to look through a one off upward blip from this devaluation of sterling in order to support economic growth, especially if pay increases continue to remain subdued and therefore little danger of increasing core inflationary price pressures within the UK economy.
18. **USA.** The American economy had a “patchy” 2015 with sharp swings in the growth rate leaving the overall growth for the year at 2.4%. Quarter 1 of 2016 disappointed at +0.8% on an annualised basis while quarter 2 improved, but only to +1.4%. However, forward indicators are pointing towards an increase in growth in the rest of 2016. The Federal Reserve (US central bank). embarked on its long anticipated first increase in rates at its December 2015 meeting. At that point, confidence was high that there would then be four more increases to come in 2016. Since then, more “downbeat” news on the international scene including the Brexit vote, have caused a delay in the timing of the second increase which is now strongly expected in December this year.
19. **EZ.** In the Eurozone, the ECB commenced in March 2015 its €1.1 trillion programme of quantitative easing to buy high credit quality government and other debt of selected EZ countries at a rate of €60bn per month; this was intended to run initially to September 2016 but was extended to March 2017 at its December 2015 meeting. At its December and March meetings it progressively cut its deposit facility rate to reach -0.4% and its main refinancing rate from 0.05% to zero. At its March meeting, it also increased its monthly asset purchases to €80bn. These measures have struggled to make a significant impact in boosting economic growth and in helping inflation to rise from around zero towards the target of 2%. GDP growth rose by 0.6% in quarter 1 2016 (1.7% y/y) but slowed to +0.3% (+1.6% y/y) in quarter 2. This has added to comments from many forecasters that central banks around the world are running out of techniques to stimulate economic growth and to boost inflation. They stress that national governments will need to do more by way of structural reforms, fiscal measures and direct investment expenditure to support demand in the their economies and economic growth.

Interest rate forecasts

20. The Council’s treasury advisor, Capita Asset Services, has provided the following forecast:

	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19
Bank rate	0.10%	0.10%	0.10%	0.10%	0.10%	0.10%	0.25%	0.25%	0.25%	0.25%	0.50%
5yr PWLB rate	1.00%	1.00%	1.10%	1.10%	1.10%	1.10%	1.20%	1.20%	1.20%	1.20%	1.30%
10yr PWLB rate	1.50%	1.50%	1.60%	1.60%	1.60%	1.60%	1.70%	1.70%	1.70%	1.70%	1.80%
25yr PWLB rate	2.30%	2.30%	2.40%	2.40%	2.40%	2.40%	2.50%	2.50%	2.50%	2.50%	2.60%
50yr PWLB rate	2.10%	2.10%	2.20%	2.20%	2.20%	2.20%	2.30%	2.30%	2.30%	2.30%	2.40%

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21. Capita Asset Services undertook its last review of interest rate forecasts after the Monetary Policy Committee (MPC) meeting of 4th August cut bank rate to 0.25% and gave forward guidance that it expected to cut Bank Rate again to near zero before the year end. The above forecast therefore includes a further cut to 0.10% in November this year and a first increase in May 2018, to 0.25%, but no further increase to 0.50% until a year later. The governor of the bank of England (BOE), has repeatedly stated that increases in Bank Rate will be slow and gradual after they do start. The MPC is concerned about the impact of increases on many heavily indebted consumers, especially when the growth in average disposable income is still weak and could well turn negative when inflation rises during the next two years to exceed average pay increases.
22. The overall trend is for gilt yields and PWLB rates to rise gently. An eventual world economic recovery may also see investors switching from the safe haven of bonds to equities. However, we have been experiencing exceptional levels of volatility in financial markets which have caused significant swings in PWLB rates.
23. The overall balance of risks to economic recovery in the UK remains to the downside. The downside risks to current forecasts for UK gilt yields and PWLB rates currently include:
- Monetary policy action reaching its limit of effectiveness and failing to stimulate significant sustainable growth, combat the threat of deflation and reduce high levels of debt in some major developed economies, combined with a lack of adequate action from national governments to promote growth through structural reforms, fiscal policy and investment expenditure.
 - Weak capitalisation of some European banks.
 - A resurgence of the Eurozone sovereign debt crisis.
 - Geopolitical risks in Europe, the Middle East and Asia, increasing safe haven flows.
 - Emerging country economies, currencies and corporates destabilised by falling commodity prices and / or Federal Reserve increases, causing a further flight to safe havens (bonds).
 - UK economic growth and increases in inflation are weaker than we currently anticipate.
 - Weak growth or recession in the UK's main trading partners - the EU and US.
24. The potential for upside risks to current forecasts for UK gilt yields and PWLB rates, especially for longer term PWLB rates include: -
- The pace and timing of increases in the Federal Reserve funds rate causing a reassessment by investors of the risks of holding bonds as opposed to equities and leading to a major move from bonds to equities;
 - UK inflation returning to significantly higher levels than in the wider EU and US, causing an increase in the inflation premium inherent to gilt yields.

Investment Portfolio 2016/17

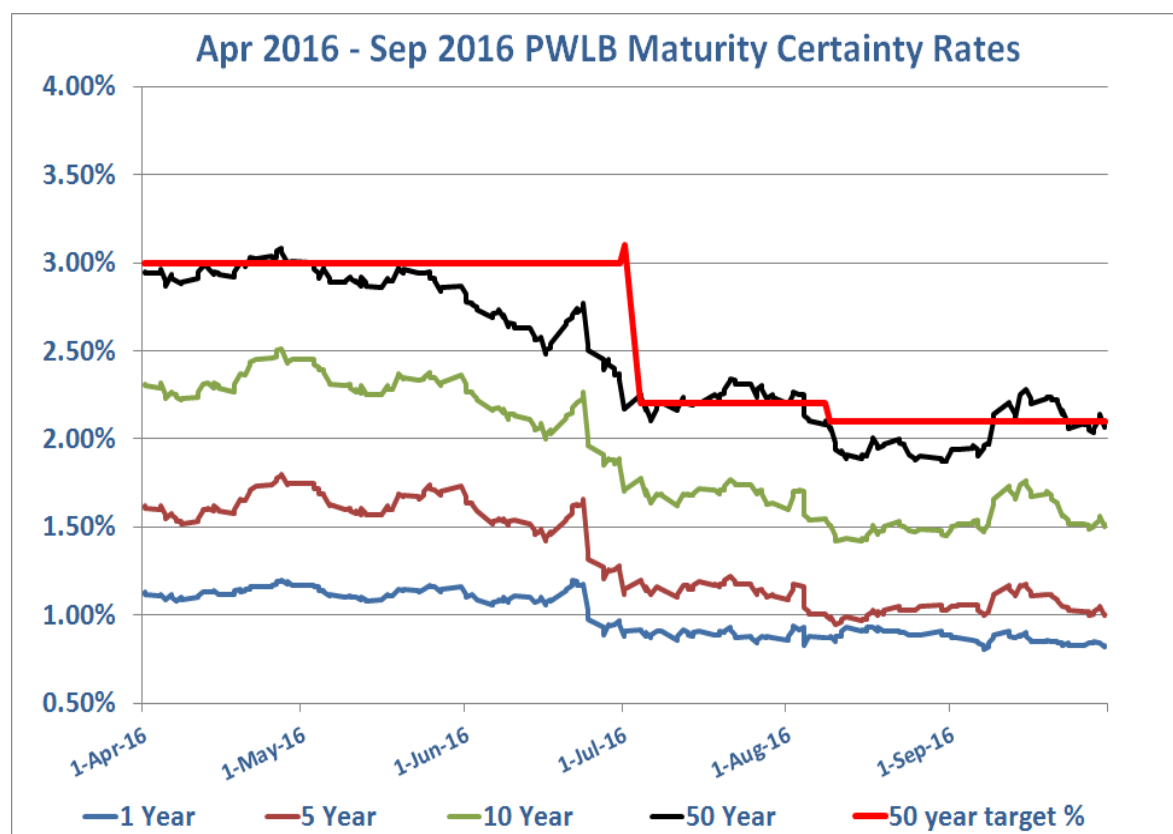
25. In accordance with the Code, it is the Council's priority to ensure security of capital and liquidity, and to obtain an appropriate level of return which is consistent with the Council's risk appetite. As set out in the "Economic Update" it is a very difficult investment market in terms of earning the level of interest rates commonly seen in previous decades as rates are very low and in line with the 0.25% Bank Rate (bank rate reduced from 0.5 to 0.25% on the 4th August 2016). The continuing potential for a re-emergence of a Eurozone sovereign debt crisis together with other risks which could impact on the creditworthiness of financial institutions, prompts a low risk strategy. Given this risk environment, investment returns are likely to remain low.
26. The Council held £135m of investments as at 30 September 2016 (£145m at 31 March 2016) with an average maturity of 67 days. These investments are predominately with UK banks, local authorities and money market funds. The investment portfolio yield for the first six months of the year is 0.60%. The standard comparator for investment performance is the benchmark 7 day rate, which for the period was 0.28%. The benchmark for 3 month deposits was 0.38%.
27. The Chief Financial Officer confirms that the approved limits within the Annual Investment Strategy were not breached during the first six months of 2016/17.

Borrowing

28. The Capital Financing Requirement (CFR) denotes the Council's underlying need to borrow for capital purposes. The Council's CFR at 31 March 2017 is estimated to be £799m. If the CFR is positive the Council may borrow from the PWLB or the market (external borrowing) or from internal balances on a temporary basis (internal borrowing).
29. The balance of borrowing between external and internal is generally driven by market conditions and forecasts of future cash flows and interest rates. At the 31st March 2016 the Council had external borrowings of £569m and has utilised £213m of internal cash in lieu of borrowing. This is a prudent and cost effective approach in the current economic climate but will require on-going monitoring in the event that upside risk to gilt yields prevails.
30. However, internal borrowing is a temporary measure that takes advantage of low interest rates and will ultimately be replaced by more expensive external borrowing as the cash used is required elsewhere. The timing and amount of new external borrowing is therefore dependent on capital spending decisions, future cash flows and forecasts of interest rates.
31. The Council are planning on borrowing £20m to take advantage of a preferential rate available from the PWLB that expires on the 31st March for the Bristol Temple Meads East Regeneration (Arena). This preferential borrowing rate is known as the "project rate" and is available for nominated infrastructure projects at a discount of 20 basis points below the certainty rate referenced in paragraph 34, below. The net financing costs of such borrowing will be contained within the existing capital financing budget.
32. Should debt financing costs continue to historic low levels, and with a significant capital programme predominately financed by borrowing the Council will consider further borrowing if rates continue to fall or are anticipated to rise at a higher pace than expected. This will enable the authority to take advantage of a low interest rate environment and reduce the interest rate risk of the authority.

33. The trend in interest rates was a decrease during the first six months of the year, across all maturity bands. The graph below show the movement in PWLB (certainty) rates for the first six months of the year to 30th September 2016:

	1 Year	5 Year	10 Year	25 Year	50 Year
1/4/16	1.13%	1.62%	2.31%	3.14%	2.95%
30/9/16	0.83%	1.01%	1.52%	2.27%	2.10%
Low	0.81%	0.95%	1.42%	2.08%	1.87%
Date	07/09/2016	10/08/2016	10/08/2016	12/08/2016	30/08/2016
High	1.20%	1.80%	2.51%	3.28%	3.08%
Date	27/04/2016	27/04/2016	27/04/2016	27/04/2016	27/04/2016
Average	0.99%	1.33%	1.92%	2.69%	2.46%



Debt Rescheduling

34. Debt rescheduling opportunities have been limited in the current economic climate given the consequent structure of interest rates. The authorities debt portfolio is made up of long dated loans (PWLB £292m, Market Debt (LOBOS) £100m and Market Debt (Fixed) £23m) averaging 35 years. The estimated penalty to repay the PWLB loans early is £248m, taking the total cost to £540m. In respect of the market loans, where indicative prices have been provided, a similar level of penalty has been quoted.

The total life cycle cost of rescheduling loans on a discounted cash-flow basis has been reviewed with no loans providing a positive cash-flow benefit to the authority. This would in part be due to large early repayment penalties that the authority will incur.

For these reasons no debt rescheduling has been undertaken during the first six months of the year and none is anticipated for the remainder of the year.

Ethical Policy

35. An Ethical Investment Policy is incorporated within the Treasury Management Practice Statements (TMPS). The City Council currently invest surplus funds with Banks and Building Societies either directly or via the Money Markets in the form of instant access cash deposit accounts, money market funds or on fixed term deposit and with other local authorities. The City Council's ethical investment policy is based on the premise that the City Council's choice of where to invest should reflect the ethical values it supports in public life. The City Council will not knowingly invest in organisations whose activities include practices which directly pose a risk of serious harm to individuals or groups, or whose activities are inconsistent with the mission and values of the City Council.

The Council's Capital Position (Prudential Indicators)

36. This part of the report is structured to update:
- The Council's capital expenditure plans;
 - How these plans are being financed;
 - The impact of the changes in the capital expenditure plans on the prudential indicators and the underlying need to borrow; and
 - Compliance with the limits in place for borrowing activity.

Prudential Indicator for Capital Expenditure

37. This table shows the latest estimates for capital expenditure:

Capital Expenditure by Service	2016/17 Original Estimate £m	2016/17 Revised Estimate £m
Non-HRA	134	166
HRA	56	56
Total	190	222

38. The latest capital monitoring report for the end of August 2016 sets out a capital budget of £222m as detailed within the period 5 monitoring report presented to Cabinet the 1st November 2016.

Financing of the Capital Programme

39. The table below draws together the capital expenditure plan and the expected financing arrangements of this capital expenditure. The borrowing element of the table increases the

underlying indebtedness of the Council by way of the Capital Financing Requirement (CFR), although this will be reduced in part by revenue charges for the repayment of debt (the Minimum Revenue Provision). This direct borrowing need may also be supplemented by maturing debt and other treasury requirements.

Capital Expenditure	2016/17 Original Estimate £m	2016/17 Revised Estimate £m
Total spend	190	222
Financed by:		
Capital receipts	29	29
Capital grants	38	67
Revenue / Reserves	10	14
HRA – Self Financing	32	32
Prudential Borrowing – Increase in Capital Financing Requirement	81	80
Total financing	190	222

Capital Financing Requirement (CFR) & Operational Boundary

40. The table below shows the CFR, which is the underlying external need to incur borrowing for a capital purpose and it also shows the expected debt position over the period. This is termed the Operational Boundary.

	2016/17 Original Estimate £m	2016/17 Revised Estimate £m
Capital Financing Requirement		
CFR – non housing	581	554
CFR – housing	245	245
Total CFR	826	799
External Debt (Operational Boundary)		
Borrowing	490	434
Other long term liabilities*	155	155
Total debt 31 March	645	589

* On balance sheet PFI schemes and finance leases etc

41. The revised Capital Financing Requirement is based on the actual CFR as at 31 March 2016 (£734m) increased by in-year capital expenditure financed by borrowing (£80m) and reduced by the minimum revenue provision (MRP) for repayment of debt (£15m) subject to a review of MRP policy being

considered by Full Council.

Limits to Borrowing Activity

42. The first key control over the treasury activity is a prudential indicator to ensure that over the medium term, net borrowing (borrowings less investments) will only be for a capital purpose. Gross external borrowing should not, except in the short term, exceed the total of CFR in the preceding year plus the estimates of any additional CFR for 2017/18 and next two financial years. This allows some flexibility for limited early borrowing for future years. The Council has approved a policy for borrowing in advance of need which will be adhered to if this proves prudent.

	2016/17 Original Estimate £m	2016/17 Revised Estimate £m
Gross borrowing	490	434
Plus other long term liabilities*	155	155
Gross borrowing & long term Liabilities	645	589
CFR* (year end position)	826	799

** Includes on balance sheet PFI schemes and finance leases etc.*

43. The Chief Finance Officer reports that no difficulties are envisaged for the current or future years in complying with this prudential indicator.
44. A further prudential indicator controls the overall level of borrowing. This is the Authorised Limit which represents the limit beyond which borrowing is prohibited, and needs to be set and revised by Members. It reflects the level of borrowing which, while not desired, could be afforded in the short term, but is not sustainable in the longer term. It is the expected maximum borrowing need with some headroom for unexpected movements. This is the statutory limit determined under section 3(1) of the Local Government Act 2003.

Authorised limit for external debt	2016/17 Original Indicator	2016/17 Revised Indicator
Total Borrowing	920	830

Proposal

45. That the Mid-Year Treasury Management report for 2016/17 is noted.

Other Options Considered

46. None

Risk Assessment

47. Borrowing and lending activity is reported to the Mayor.

The principal risks associated with treasury management are:

- The risk of loss as a result of failure of counterparties.
- This is mitigated by limiting the types of investment instruments used, setting lending criteria for counterparties, and limiting the extent of exposure to individual counterparties;
- The risk of loss as a result of borrowing at high rates of interest/lending at low rates of interest.

This is mitigated by planning and undertaking borrowing and lending in the light of advisers' assessments of future interest rate movements, and by undertaking most long term borrowing at fixed rates of interest (to reduce the volatility of capital financing costs).

Public Sector Equality Duties

48. a) Before making a decision, section 149 Equality Act 2010 requires that each decision-maker considers the need to promote equality for persons with the following “protected characteristics”: age, disability, gender reassignment, pregnancy and maternity, race, religion or belief, sex, sexual orientation. Each decision-maker must, therefore, have due regard to the need to:
- i) Eliminate discrimination, harassment, victimisation and any other conduct prohibited under the Equality Act 2010.
 - ii) Advance equality of opportunity between persons who share a relevant protected characteristic and those who do not share it. This involves having due regard, in particular, to the need to --
 - remove or minimise disadvantage suffered by persons who share a relevant protected characteristic;
 - take steps to meet the needs of persons who share a relevant protected characteristic that are different from the needs of people who do not share it (in relation to disabled people, this includes, in particular, steps to take account of disabled persons' disabilities);
 - encourage persons who share a protected characteristic to participate in public life or in any other activity in which participation by such persons is disproportionately low.
 - iii) Foster good relations between persons who share a relevant protected characteristic and those who do not share it. This involves having due regard, in particular, to the need to –
 - tackle prejudice; and
 - promote understanding.
- b) There are no proposals in this report, which require either a statement as to the relevance of public sector equality duties or an Equalities Impact Assessment.

Legal and Resource Implications

Legal

The Council is under a duty to manage its resources prudently and therefore due consideration must always be given to its borrowing and lending strategy. A wide range of local authority financial activities, including borrowing, lending, financial management, and the approval of types of investment vehicle are governed by legislation and various regulations. The Council is obliged to comply with these.

(Legal advice provided by Shahzia Daya - Service Director - Legal and Democratic Services)

Financial

(a) Revenue

(Financial advice provided by Jon Clayton (Corporate Accountant))

(b) Capital

Not applicable

Land

Not applicable

Personnel

Not applicable

Appendices:

None

LOCAL GOVERNMENT (ACCESS TO INFORMATION) ACT 1985

Background Papers:

None